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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-90319; File No. SR-CBOE-2020-014]

Self-Regulatory Organizations; Cboe Exchange, Inc; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, to Adopt the Delta-Adjusted at Close Order Instruction

November 3, 2020.

I.   Introduction

On February 18, 2020, Cboe Exchange, Inc. ("Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to introduce the Delta-Adjusted at Close ("DAC") Order Instruction on the Exchange. The proposed rule change was published for comment in the Federal Register on March 9, 2020.[3] On April 13, 2020, the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether the proposed rule change should be disapproved.[4] On May 12, 2020, the Exchange submitted Amendment No. 1 to the proposed rule change.[5] On June 3, 2020, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.[6] On September 3, 2020, the Commission designated a longer

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[1]   15 U.S.C. 78s(b)(1).

[2]   17 CFR 240.19b-4.

[3]   See Securities Exchange Act Release No. 88312 (March 3, 2020), 85 FR 13686 ("Notice").

[4]   See Securities Exchange Act Release No. 88622, 85 FR 21490 (April 17, 2020).

[5]   See https://www.sec.gov/comments/sr-cboe-2020-014/srcboe2020014-7180918-216787.pdf

[6]   See Securities Exchange Act Release No. 88997, 85 FR 35351 (June 9, 2020) ("Order Instituting Proceedings").

period for Commission action on proceedings to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.[7] The Commission has received one comment on the proposed rule change.[8] This order approves the proposed rule change, as modified by Amendment No. 1.

II.   Summary of the Proposed Rule Change, as Modified by Amendment No. 1

      A. Proposed DAC Order Instruction - Generally

As modified by Amendment No. 1, the Exchange proposes to implement a DAC order instruction that a User[9] may only apply to an order upon System[10] entry (including each leg of a complex order) for an option on an Exchange Traded Product ("ETP") or index for execution in a FLEX electronic or open outcry auction.[11] A DAC order could execute throughout the trading day. After the close of trading and upon receipt of the official closing price or value for the underlying ETP or index from the primary listing exchange or index provider, as applicable, the System would adjust the original execution price of the order based on a pre-determined delta value applied to the change in the underlying reference price between the time of execution and the market close.

The Exchange states that there can be substantial activity in an underlying near the market close that may create wider spreads and increased price volatility in the underlying, which may attract additional trading activity from market participants seeking arbitrage

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[7]   See Securities Exchange Act Release No. 89765, 85 FR 55905 (September 10, 2020).

[8]   See Letter from Kurt Eckert, Partner, Wolverine Execution Services, LLC, to Vanessa Countryman, Secretary, Commission, dated June 24, 2020 ("WEX Letter"), available at https://www.sec.gov/comments/sr-cboe-2020-014/srcboe2020014-7343517-218670.pdf.

[9]   The term "User" means any TPH or Sponsored User who is authorized to obtain access to the System pursuant to Rule 5.5. See Rule 1.1.

[10]   The term "System" means the Exchange's hybrid trading platform that integrates electronic and open outcry trading of option contracts on the Exchange, and includes any connectivity to the foregoing trading platform that is administered by or on behalf of the Exchange, such as a communications hub. See Rule 1.1.

[11]   For a more detailed description of the proposed rule change, as modified by Amendment No. 1, see Order Instituting Proceedings, supra note 6. See also supra note 5.

opportunities and further increase volatility. This activity near market close makes it difficult to execute FLEX option orders based on the exact closing price or value of the underlying ("execution risk").[12] The Exchange states that the DAC order is designed to allow Users to incorporate into the pricing of their FLEX options the closing price or value of the underlying ETP or index on the transaction date based on how much the price or value changed during the trading day. The Exchange also represents that DAC orders will have unique message characteristics such that contra-side interest will be aware of, and may choose whether to interact with, the DAC order. Finally, the Exchange believes that the DAC order would be particularly useful for investors that participate in defined outcome strategies, including defined-outcome exchange-traded funds ("ETFs"), other managed funds, unit investment trusts ("UITs"), index funds, structured annuities, and other such funds or instruments that are indexed.

B. DAC Orders and FLEX Options

As stated above, the use of the DAC order instruction is limited to the trading of an option on an ETP or index for execution in a FLEX electronic or open outcry auction, and would be handled and executed in the same manner as any other FLEX option order pursuant to the applicable FLEX auction rules, including pricing, priority, and allocation rules.[13] Specifically, pursuant to Rules 5.72, 5.73, and 5.74, FLEX Orders (including proposed DAC orders) may only execute in a FLEX electronic or open outcry auction which would include the FLEX Automated Improvement Auction,[14] the FLEX Solicitation Auction Mechanism or,[15] a FLEX order submitted for manual handling in an open outcry auction on the Exchange's trading floor.[16] Pursuant to proposed Rule 5.33(b)(5), a DAC order instruction may be used in conjunction with

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[12]   See Order Instituting Proceedings, supra note 6, at 35352.

[13]   See Rules 5.72(b), (c), and (d).

[14]   See Rule 5.73.

[15]   See Rule 5.74.

[16]   See Rule 5.72(d).

complex orders that are submitted for execution in a FLEX complex electronic or open outcry auctions pursuant to proposed Rule 5.72.

The DAC order instruction may not be used with all FLEX orders. Specifically, proposed Rule 5.70(a)(2) sets forth that a User may not apply the DAC order instruction to a FLEX order for a FLEX option series with an exercise price formatted as a percentage of the closing value of the underlying on the trade date. In other words, the exercise price of a DAC order must be expressed as a fixed price in dollars and decimals because otherwise, according to the Exchange, the formatting would not be compatible with the DAC order instruction. Proposed Rule 5.70(a)(2) also prohibits the use of the DAC order instruction with FLEX Option series that are Asian or Cliquet-settled because DAC orders would be based on the movement of the underlying on the transaction date but the prices for Asian or Cliquet-settled options are determined by averaging a pre-set number of closing index values or summing the monthly returns, respectively, on specified monthly observation dates.[17]

C. Delta and Reference Prices

As stated above, the original execution price of a DAC order that executes during the trading day would be delta-adjusted at the market close upon receipt of the official closing price or value for the underlying ETP or index from the primary listing exchange or index provider, as applicable.[18] Delta is the measure of the change in the option price as it relates to a change in the price of the underlying security or value of the underlying index, as applicable. For example, an option with a 50 delta (which is generally represented as 0.50) would result in the option moving $0.50 per $1.00 move in the underlying (i.e., price move in the underlying x delta value = anticipated price move in the option). The delta changes as a result from the passage of time and

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[17]   See Rule 4.21(b)(5)(B).

[18]   According to the Exchange, like the execution price of any option, a delta-adjusted price may never be zero or negative and the System would instead set the delta-adjusted price to the minimum permissible increment if such a calculation were to occur. See Order Instituting Proceedings, supra note 6, at 35353.

changes to the price or value of the underlying stock or index changes, and provide Users with an estimate of how an option reacts to movement, in either direction, of the underlying. For example, call option deltas are positive (ranging from 0 to 1), because as the underlying increases in price so does a call option. Conversely, put option deltas are negative (ranging from -1 to 0), because as the underlying increases in price the put option decreases in price. Specifically, the delta-adjusted execution price would equal the original execution price plus the delta value times the difference between the official closing price or value of the underlying on the transaction date and the reference price or index value of the underlying ("reference price").

A User entering a DAC order for a FLEX electronic auction must designate a delta value and may designate a reference price.[19] If no reference price is designated, the System would include the price or value, as applicable, of the underlying at the time of order entry as the reference price.[20] A User entering a DAC order for a FLEX open outcry auction may, but is not required to, designate a delta value and/or a reference price.[21] During the FLEX open outcry auction, the User designated delta value or reference price may differ from the final terms of the order because in-crowd market participants[22] can negotiate the final delta value and/or reference price.[23] A User entering a complex order with a DAC order instruction into a FLEX electronic auction is required to designate a delta value for each leg of the complex order pursuant to proposed Rule 5.33(b)(5)).[24]

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[19]   See proposed Rules 5.6(c) and 5.33(b)(5).

[20]   See id.

[21]   See proposed Rules 5.6(c) and 5.33(b)(5).

[22]   The Exchange states that in-crowd participants currently have delta values built into their own analytics and pricing tools and that there is generally only a slight difference of values across participants. See Order Instituting Proceedings, supra note 6, at 35353, n. 25.

[23]   See id.

[24]   See proposed Rule 5.72(b)(2)(A).

User-designated reference prices will be subject to a reasonability check to determine if the DAC order would be cancelled or rejected by the System for being more than an Exchange-determined amount away from the underlying price or value at the time of submission.[25] In addition, if a DAC order is submitted without a reference price, the System would automatically input a reference price equal to the price or value of the underlying at the time of order entry.[26] The ultimate delta value and reference price would be reflected in the final terms of the execution.[27]

The Exchange represents that its electronic and open outcry FLEX auctions currently last between three seconds to five minutes as designated by the Submitting/Initiating FLEX Trader.[28] Accordingly, to the extent a DAC order executes in a FLEX auction, it would do so within the three second to five minute timeframe which should limit the impact of time on the delta and reference price and help investors meet their goal of limiting downside risk while still being able to participate in any upward movement in the market.

D. Time-in-Force

Proposed Rule 5.6(c) sets forth that a DAC order submitted for execution in open outcry may only have a Time-in-Force of Day.[29] If not executed, an order with a Time-in-force of Day would expire at Regular Trading Hours ("RTH") market close. Proposed Rule 5.6(c) also provides that a User may not designate a DAC order as All Sessions (i.e., eligible for RTH and

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[25]   The System will use the most recent last sale (or disseminated index value) as the reference price. See proposed Rule 5.34(c)(12).

[26]   See proposed Rules 5.6(c) and 5.33(b)(5).

[27]   See id. The Exchange provided examples to demonstrate how the System would apply the delta adjustment formula to DAC orders a t the market close. See Order Instituting Proceedings, supra note 6, at 35353-54.

[28]   See Rules 5.72(c), 5.73(c)(3) and 5.74(c)(3).

[29]   The Exchange notes that electronically submitted DAC orders will be submitted through the electronic auctions, and either executed or cancelled upon the conclusion of an auction, making an instruction regarding the time the System will hold an order unnecessary. Therefore, the Exchange believes that a requirement to apply a Time-in-Force of Day is not necessary for electronic DAC orders.

Global Trading Hours),[30] as the adjustment calculation for DAC orders is linked to the RTH

market close for the underlying securities and indexes.[31] The Exchange explained that the

proposed Time-in-Force of Day requirement for DAC orders submitted for execution in open

outcry correlates with the need for any execution to occur within a limited timeframe after the

order's entry in order to achieve the result desired by the broker's customer.[32]

E. Trade Reporting

When a DAC order is executed, the time of the execution, original execution price, the

reference price and delta value will be provided to all transaction parties on all fill reports (i.e.,

an "unadjusted DAC trade").[33] Unadjusted DAC trade information will also be sent to the

Options Clearing Corporation ("OCC") and disseminated to Options Price Reporting Agency

("OPRA").[34] Like all FLEX Orders, DAC order trade information will be reported via a text

message to OPRA[35] reflecting the (1) execution of a DAC order, (2) delta, and (3) reference

price.[36] Like all complex orders, the individual legs of DAC complex orders would be reported

with an identifier to indicate that they are part of a complex order.[37] At the market close, when

the execution price is delta-adjusted, all transactions parties will be sent fill restatements.

Matched trades with the delta-adjusted price will also be sent to the OCC and OPRA once the

restatement process is complete. The prior unadjusted DAC trade report that was sent to the

OCC and disseminated to OPRA will be cancelled and replaced with a trade report reflecting the

delta-adjusted execution price. The remaining information (i.e., time of the execution, delta, and

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[30]   See Rule 1.1.

[31]   See proposed Rules 5.6(c) and 5.33(b)(5).

[32]   See Order Instituting Proceedings, supra note 6, at 35354-55.

[33]   See id.

[34]   See id.

[35]   See id.

[36]   See id.

[37]   See id.

reference price) would be unchanged.[38] A new DAC order text message would be disseminated to OPRA with the same information included in the original text plus the closing price. The Exchange states that OCC and OPRA are aware of, and deem acceptable, this proposed restatement process.[39]

F. System Capacity and Surveillance

The Exchange represents that it believes: (1) the Exchange and OPRA have the necessary systems capacity to handle any additional order traffic, and the associated restatements, that may result from the use of DAC orders, and (2) its surveillance program is adequately robust to monitor orders with delta-adjusted pricing, and (3) the DAC order will not have any impact on pricing or price discovery at or near the market close.[40]

III   Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[41] In particular, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(5) of the Act,[42] which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

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[38]   The Exchange notes that this restatement process is the same for an order that has been adjusted or nullified and subsequently restated pursuant to the Exchange's obvious error rules. See Rule 6.5.

[39]   See Order Instituting Proceedings, supra note 6, at 35355.

[40]   See id.

[41]   In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

[42]   15 U.S.C. 78f(b)(5).

The Exchange proposes to introduce the DAC order instruction for use with both simple and complex orders for FLEX options on ETPs and indexes in electronic or open outcry auctions. The DAC order would execute during the trading day and the original execution price would be adjusted after receipt of the official closing price/value for the underlying ETP or index from the primary listing exchange or index provider, as applicable, based on a delta value applied to the change in the underlying reference price between the time of execution and the market close. The Exchange states that the introduction of the DAC order instruction will allow market participants to incorporate into the pricing of their FLEX options the closing price of the underlying ETP or index on the transaction date, based on the amount in which the price or value of the underlying ETP or index changes intraday. The Exchange also states that the DAC order will be useful to investors that engage in defined-outcome strategies and that certain market participants, managed funds in particular, already use similar strategies at the market close.

The Commission received one comment letter supporting the Exchange's proposal.[43] The commenter agrees with the Exchange that there may be dislocations in the closing price of a FLEX option and its execution price,[44] and that the DAC order would eliminate such dislocations while limiting downside risk and allowing users to incorporate any upside market moves that may occur following the execution of the order up to the market close.[45] The commenter also believes that the DAC order will improve the efficiency of the options market.[46]

The Commission believes that the DAC order instruction is designed to remove impediments to and perfect the mechanism of a free and open market by allowing market participants to more effectively incorporate the closing price of the underlying ETP or index into the execution price of the FLEX option, which should facilitate the ability of market participants

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[43]   See WEX Letter, supra note 8.

[44]   See id. at 1.

[45]   See id.

[46]   See id. at 2.

to execute certain investment strategies. Specifically, as the Exchange notes, the DAC order instruction would allow FLEX option orders to be executed anytime during the trading day, eliminating execution risk near the market close and thereby realizing the objective of pricing based on the exact underlying closing prices. The Commission believes that the proposal is designed to protect investors by providing them with a mechanism designed to ensure FLEX option pricing certainty based on the closing price of the underlying ETP or index and to eliminate execution risk near the market close, which should effectively implement their investment strategies. The Commission agrees with the Exchange that, at this time, it is appropriate to limit the use of the DAC order instruction to FLEX options on ETPs and indexes as the stated goal of the DAC order instruction is to assist investors that participate in defined-outcome investment strategies, including defined-outcome ETFs, other managed funds, UITs, index funds, structured annuities, and other such funds or instruments that are indexed.

The Commission believes that DAC orders are designed promote just and equitable principles of trade as their operation should be transparent to market participants and the implementation of DAC orders should not raise any new or novel order entry, allocation, and execution processes. For instance, DAC orders will be entered and processed pursuant to the existing FLEX rules like any other order that is submitted into a FLEX electronic or open outcry auction.[47] The Commission also believes that the proposed delta adjustment of DAC orders is designed to promote just and equitable principles of trade and to remove impediments to and perfect the mechanism of a free and open market because it is consistent with the general manner in which deltas function. The Exchange has designed the proposal to limit the period between entry and execution of a DAC order. Because the Exchange's electronic and open outcry FLEX auctions currently last between three seconds to five minutes, DAC orders should generally execute within a timeframe that limits the impact of the passage of time on the delta and

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[47]   See Rules 5.72(d).

reference price. Taken together, the Commission believes that the DAC order is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors by providing a mechanism to effectively implement certain investment strategies to market participants that should have familiarity with the design and strategy of the order type.

Finally, the Exchange represents that: (1) DAC orders will have unique message characteristics that will indicate to contra-side interest its status as a DAC order which will allow market participants to choose whether to interact with DAC orders, (2) the OCC and OPRA are able to accommodate the DAC restatement process, (3) the Exchange and OPRA have the necessary systems capacity to handle additional order traffic, and the associated restatements, that may result from the use of DAC orders, (4) the Exchange's surveillance program will monitor the pricing of DAC orders, and (5) DAC orders should not have any impact on pricing or price discovery in the underlying products at or near the market close.

Accordingly, for the foregoing reasons, the Commission believes that this proposed rule change, as modified by Amendment No. 1, is consistent with the Exchange Act.

IV.   Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[48] that the proposed rule change (SR-CBOE-2020-014), as modified by Amendment No.1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[49]

J. Matthew DeLesDernier,

Assistant Secretary.
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[48]   15 U.S.C. 78s(b)(2).

[49]   17 CFR 200.30-3(a)(12).